No. 15,201

United States Court of Appeals

For the Ninth Circuit

RALPH E. WILLIAMS, as Trustee in Bankruptcy of the Estate of George F. Elliff, an individual doing business as Pine Supply Co., bankrupt, and PEARL K. LANNIN, *Appellants,* vs. TWIN CITY COMPANY, TWIN CITY LUMBER CO., JOHN W. HUNTER, FRANKLIN SUPPLY CORPORATION, SOUTHWEST MANAGEMENT CORP., H. A. COLLINS, and WILLIAM R. RAMSAY, *Appellees.*	

Appeal from the United States District Court for the Northern District of California, Southern Division.

Honorable O. D. Hamlin, Judge.

APPELLANTS' OPENING BRIEF.

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Subject Index

Table of Authorities Cited

Cases

Statutes

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RALPH E. WILLIAMS, as Trustee in Bankruptcy of the Estate of George F. Elliff, an individual doing business as Pine Supply Co., bankrupt, and PEARL K. LANNIN,

Appellants,

vs.

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APPELLANTS' OPENING BRIEF.

LEGAL PROCEEDINGS TO DATE.

On July 10, 1954, in the United States District Court for the Northern District of California, Southern Division, one of the creditors of George F. Elliff herein called the Bankrupt, filed a petition for the

involuntary adjudication of said Elliff. Thereupon the said Court adjudged said George F. Elliff to be a Bankrupt and appointed Ralph E. Williams as Trustee in Bankruptcy. The Trustee thereafter instituted summary proceedings against Pearl K. Lannin, who claimed ownership of the stock in trade located in the Bankrupt's place of business, by virtue of warehouse receipts issued to her pursuant to the "Trust Agreement," a copy of which was made an exhibit to the complaint herein. Pearl K. Lannin attempted, by petition, in said summary proceedings, to join Twin City Lumber Company, defendant herein, and an order joining Twin City Lumber Company was made. Motion was thereupon made by Twin City Lumber Company, to dissolve the joinder and dismiss the proceeding as against itself, and the motion was granted. Subsequent thereto the said summary proceedings were concluded with an order denying the claim of Pearl K. Lannin to the Bankrupt's stock in trade and concluding that the said Trust Agreement and warehouse receipts were wholly ineffectual and void as against the Trustee. This order was made subsequent to the filing of the action upon which this appeal is made, but prior to the trial thereof.

The action herein was brought by the said Trustee in Bankruptcy against Twin City Lumber Company, Twin City Co., John W. Hunter, Franklin Supply Corporation, Southwest Management Corp., H. A. Collins and William R. Ramsay (grouped for convenience hereafter as the Twin City defendants), and

against Pearl K. Lannin and Audrey Mae Elliff, based upon a complaint setting forth four counts therein. Pearl K. Lannin thereupon cross-complained against the Twin City defendants.

Trial was duly held before the Court, sitting without a jury, and judgment was rendered for the trustee against the Twin City defendants on Count Three of his complaint, and against the Trustee on Counts One, Two and Four of his complaint. Judgment was also rendered against Pearl K. Lannin on her cross-complaint.

This Appeal is now taken by the Trustee on the judgment against the Trustee on Counts One and Four of his complaint, and by Pearl K. Lannin on the judgment against her on her cross-complaint.

STATEMENT OF FACTS.

In 1953 George Elliff, the Bankrupt was engaged in the retail lumber business in the city of San Jose. He purchased a large part of his stock in trade from Twin City Lumber Co. a Los Angeles wholesaler. All of the respondents in this case are similarly situated as to their legal position in this case and for purposes of convenience hereinafter they will be referred to simply as Respondent unless specifically referred to by proper name. Due to the Bankrupt's poor record of payment an agreement was made whereby the Bankrupt's stock in trade was put into a field warehouse on his premises and as security for the obliga-

tion to it Respondent was given the warehouse receipts. This took place in May and gave Respondent as a practical matter the power to prevent the Bankrupt from continuing in business.

Subsequent to this the Bankrupt continued in business but issued bad checks to Respondent in payment of obligations to it and finally Respondent informed the Bankrupt that he would either have to pay the obligations or else some new and more satisfactory arrangement would be necessary to prevent Respondent from closing down the business which the respondent did close prior to the October Transaction. Respondent visited the Bankrupt in San Jose and went over his affairs in detail although it appears that the Bankrupt may not have disclosed to Respondent some non-business debts he had. After conferences and discussions in late September and early October the Bankrupt made a small cash payment, executed a note for $28,000 to Respondent and concluded a Trust Agreement whereby the Bankrupt transferred his stock in trade and assigned his accounts receivable in trust to his attorney as trustee. He also undertook an obligation as stated in the Trust Agreement to transfer all future stock in trade whether or not purchased from Respondent and to assign all future accounts receivable to the trust. The stock in trade had a value of some $25,000 and the accounts receivable were in the amount of $25,000 although listed in the trust agreement as $17,000. Respondent turned over its warehouse receipts to the warehouse company and new ones were issued to Pearl K. Lannin, the Bank-

rupt's mother-in-law. Mrs. Lannin guaranteed the Bankrupt's note to Respondent. Respondent did not give up its warehouse receipts until it had received copies of the note and trust agreement and a financial statement of Mrs. Lannin.

The trust agreement named Mrs. Lannin as beneficiary but it also provided that 20% of all receipts of the trust were to be set aside for Respondent to make payments on the note. It provided for a salary to the Bankrupt and permitted the trustee to make payments to other creditors but provided that in no event should any payments be made that would touch the 20% for Respondent.

At the conferences in San Jose previously mentioned Respondent sought to have the figure of 30% set aside for his benefit but finally settled on 20%. At one of the conferences in the offices of the attorney who became the trustee, the attorney mentioned the possibility that a notice to creditors under the provisions of California Civil Code Section 3440 might be necessary. The matter was discussed and it was agreed that notice might be disastrous and should not be given. Respondent's agent stated that he took no part in that phase of the discussion but admitted knowledge of it.

Although the Bankrupt had transferred title to his business he continued to run it as the Trust Agreement provided he should do Respondent had permitted the reopening of the Bankrupt's business upon the completion of the October Transaction. Creditors of the Bankrupt at the time of the October transac-

tion remained creditors at the time of bankruptcy and held and hold provable claims against the Bankrupt. Pursuant to that transaction payments were made to Respondent. Bankruptcy occurred the following June.

In the bankruptcy proceedings, the Referee held that the October transaction was a fraudulent conveyance under Section 67d as to the creditors of the Bankrupt, and thus held that Mrs. Lannin obtained no rights under it.

LEGAL ISSUES.

1. Did the Bankrupt have an actual intent to hinder, to delay or to defraud any of his creditors by means of the October transaction?

2. Did the Bankrupt transfer any property or incur any obligations to or for the benefit of Respondent under the October transaction?

3. Was the property remaining in the hands of the Bankrupt after such transfer or obligation an unreasonably small capital for his business?

4. Was the Bankrupt insolvent at the time of the October transaction or rendered insolvent thereby?

5. Did the Respondent give the Bankrupt fair consideration as defined by Section 67 of the Bankruptcy Actor California Civil Code Section 3439?

6. Does the fraudulent character of the transaction of which it was a part, render the promissory note invalid and unenforceable against the Bankrupt, and therefore the guarantor?

ARGUMENT.

I.

INTRODUCTION.

The efforts of creditors to collect from their debtors and the efforts of debtors, honest and otherwise, to escape or to delay payment have produced a substantial segment of law. As the efforts of debtors became recognized and stereotyped, laws were passed to prevent or limit their methods. As new ways were fashioned by debtors to sidestep these laws new statutes were developed to counter the action of the debtors. This field of law is a dynamic one as ingenious debtors impelled by the threat or the existence of insolvency try to salvage something for themselves and lawmakers strive to keep these efforts within the bounds of our concepts of fairness and justice.

At times the debtor feels, rightly or wrongly, that a respite from his difficulties, temporary though it may be can be gained by giving a special favor to a certain creditor or creditors. Customarily the favored creditors are those who are most insistent in their threats or those who are in position to do the Bankrupt's business the most harm. The action favoring the creditor may be solely the Bankrupt's idea but it often results from the collusion or at least the strong suggestion of the creditor. Many of these efforts at favoritism are not permissible as being unfair to the debtor's other creditors.

The relationships of debtors and creditors are prescribed and circumscribed by many laws. Among them are laws relating to bankruptcy, bulk sales, ob-

tained and perfecting security devices such as mortgages, pledges and warehouse receipts and the laws relating to various types of liens. Also included are statutes covering what are perhaps unfortunately entitled "fraudulent conveyances." It is misleading to use the word "fraudulent" which often connotes conduct bordering on the criminal to describe conduct in which by the express words of the statute, actual intent may be immaterial. An honest effort to pay an honest debt may under the statutes be a fraudulent conveyance. It is nevertheless forbidden as unfair to other creditors just as similar honest efforts to pay honest debts may be forbidden as preferences.

In the instant case the Respondent was a creditor who was in a position to do the Bankrupt's business great harm. It insisted that some arrangement satisfactory to it be made and ordered the Bankrupt to cease to operate until that time. An arrangement was made which gave Respondent a favored position unavailable to other creditors. The trial court agreed that this conduct was unfair to other creditors to the extent that money paid pursuant to the October agreement and within 4 months of bankruptcy was a preference. It failed to find that the transfers and the obligations under which that money was preferentially paid were "fraudulent conveyances." This was error.

This is a case of first impression on some of the phases of the law concerned. Our research has turned up very little authority on the questions involved.

II.

THE OCTOBER TRANSACTION IS A FRAUDULENT CONVEYANCE UNDER THE PROVISIONS OF BANKRUPTCY ACT SECTION 67d 2(d) AND UNDER CALIFORNIA CIVIL CODE SECTION 3439.07.

The Uniform Fraudulent Conveyance Act based upon the old Statute of 13 Elizabeth is the source of the provisions of both Section 67d of the Bankruptcy Act and Section 3439 of the California Civil Code. The trustee has the right to assert a claim under both. As the corresponding subsections are virtually identical in language the arguments to be made will be applicable under both statutes.

Section 67d 2(d) of the Bankruptcy Act reads:

> "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this act by or against him is fraudulent as to then existing and future creditors if made or incurred with actual intent as distinguished from intent presumed in law to hinder, delay or defraud either existing or future creditors."

The Bankrupt had an actual intent to hinder and to delay his creditors in this case. The proof of intention to hinder or delay is proof of actual fraud required by the section. *Lovett v. Faircloth,* 10 F.2d 301; *Rose v. Rose,* 271 N.Y.S. 5, 241 App. Div. 3; *M & N Freight Lines v. Kimbel Lines,* 180 Tenn. 1, 170 S.W.2d 186.

The intent to hinder and to delay was shown by evidence of a determination to withhold from other

creditors of the bankrupt, present or future and notice of the October transaction. Without prolonging this brief with extensive quotations from the Transcript of Record we respectfully call the courts attention to the fact that a conversation took place in early October at the offices of Louis Pasquinelli Esq. attorney for the Bankrupt at which Mr. Pasquinelli, Mr. Baum the Bankrupt's accountant, the Bankrupt and Mr. Ramsay, one of the Respondents were present. At that conversation the matter of notice to creditors was suggested as necessary by Mr. Pasquinelli. After a discussion in which it was pointed out that such notice might be disastrous it was agreed that no notice be given. (Testimony of Pasquinelli Tr. Rec. p. 147; of the Bankrupt Tr. Rec. p. 176; of accountant Baum Tr. Rec. p. 251 and of Respondent Ramsay Tr. Rec. p. 528.) Respondent Ramsay admits that there was such a conversation in his presence but although he admitted his memory was not too clear on the details of the October transaction he did deny that he took an active part in that phase of the conversation. The others present remembered otherwise. However there is apparently no dispute of the fact that Respondents closed the Bankrupts operation down and told him some satisfactory arrangement had to be made on the debt, that Respondent knew of the conversation decribed above at which it was determined that notice would not be given, that the Trust Agreement contained a provision that future accounts receivable would be turned over to the trust and no

notice given to the debtors thereon, and that Respondents did not release the warehouse receipts they held unil receiving executed copies of the note and Trust Agreement.

It is clear and unmistakable that the Bankrupt intended to hinder and delay his creditors, existing and future by concealing from them the facts of the October transaction and that Respondent had a similar intent. While there is no direct admission of the fraudulent intent by Respondent proof of fraud may come by inference from circumstances surrounding the transaction, the relationship and interest of the parties. *Menick v. Goldy,* 131 C.A.2d 542; 280 P.2d 844. Thus Finding of Fact IX of the court below is in error as it is contrary to undisputed evidence.

One final factor should be noted. The substance of this transaction was that the Bankrupt transferred title to his business and assets and yet retained benefits and practical control. This has always been regarded as fraudulent. *Heath v. Helmick* (1949), USCA 9th, 173 F.2d 157; *In re Cummins Const. Corp.* (1948 USDC Md.) 81 F. Supp. 193; *Kane v. Sesac Inc.* (1944 USDC N.Y.) 54 F. Supp. 193; *Com. Trust Co. of Pittsburgh v. Cirigliano,* 352 Pa. 108, 41 A.2d 863.

III.

THE OCTOBER TRANSACTION IS A FRAUDULENT CONVEYANCE UNDER THE PROVISIONS OF BANKRUPTCY ACT SECTION 67d 2(b) AND CALIFORNIA CIVIL CODE SECTION 3439.05.

Section 67d 2(b) provides:

> "Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent as to the existing creditors and as to other persons who become creditors during the continuance of a business or transaction if made or incurred without fair consideration by a debtor who is engaged or who is about to engage in such business or transaction for which the property remaining in his hands is an unreasonably small capital, without regard to his actual intent."

There are very few reported cases on this section or its equivalent under the Uniform Fraudulent Conveyance Act. We find nothing directly in point on what constitutes an unreasonably small capital and will argue from the facts in evidence.

About all the bankrupt had of value in the business was his stock in trade and his accounts receivable. He was to conclude the October transaction whereby he was to transfer the stock in trade and the accounts receiveable in trust for the benefit of Respondent and others but was to continue to run the business. We believe it has never been the claim of respondents that as a part of the October transaction the Bankrupt actually received anything which had a value which could be turned into cash for creditors. Thus the

bankrupt transferred his assets and maintained his obligations. This is compelling evidence that the Bankrupt was left with an "unreasonably small capital" in order to transact business. Virtually no capital is an "unreasonably small capital."

Even if we should disregard the change in ownership caused by the trust and merely consider the obligations it imposed we see an unreasonably small capital.

The Bankrupt testified that his average gross markup on his merchandise was 20%. (Tr. Rec. p. 348.) As he continued to purchase merchandise and pay for it he would have 20% over its cost with which to work. From that he had to cover his overhead, his salary of $400 per month plus fuel expenses, interest on the $28,000 due Respondent, the trust costs and fees, etc. Yet 20% of all moneys had to be earmarked for the Respondent. It is clear that the Bankrupt had no working capital and the need for such was shown by the letters comprising Plaintiff's Exhibit 3. The plaintiff had a number of slow accounts. We think it is obvious that no business which sells on credit can earmark for liquidation of an old obligation an amount equivalent to its gross profit and yet have enough capital to operate.

The Trust Agreement although not naming Respondent in so many words as a beneficiary makes Respondent a beneficiary by the provisions earmarking the 20% of all moneys received for liquidation of the obligation to it. Thus the transfer to the trust or the

obligation to transfer to the trust the stock in trade and the present and future accounts receivable was a transfer made and an obligation incurred by a debtor within the meaning of the statute.

The only remaining question is whether there was fair consideration for the Bankrupts transfer. "Fair consideration" is defined by Bankruptcy Act Section 67d 1(e) as follows:

> "Consideration given for the property or obligation of a debtor is "fair" (1) when, in good faith, in exchange and as a fair equivalent therefor property is transferred or an antecedent debt is satisfied or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disapportionately small as compared with the value of the property or obligation obtained."

We assume that the only serious examination that need be made of the above definition is of part (1) thereof for part (2) refers to a transfer by the alleged fraudulent transferor for security for an obligation. The note given in the October transaction to Respondent was evidence of an obligation and no one would claim that a note was *security* for the obligation. Nor were the transfers in trust or the obligations to transfer security to Respondents for the obligation to them. The Bankrupt provided Respondent with no collateral for the obligation upon which Respondent might realize in the customary sense of the word "security."

As to part (1) of the statutory definition Respondent claimed and the court found that no antecedent

debt was satisfied by he October transaction. This leaves the question of whether Respondent transferred property in good faith, in exchange for the note and the transfers in trust by the bankrupt. The answer is no.

The only possibility of any transfer of property by Respondent was the transfer of the warehouse receipts it held covering most of the Bankrupt's stock in trade. This certainly could be property within the meaning of the statute.

Respondent's lack of good faith is shown in the discussion above in relation to the attempt to conceal the October transaction from creditors.

Respondent, however, did not really give up the security of the warehouse receipts for the receipts were transferred to Mrs. Lannin who was a guarantor of the Bankrupt's obligation to Respondent, and thus the benefit of the receipts was still available to Respondents. California Civil Code section 2854. Thus if we regard the substance of the transaction there was no transfer by Respondent and no fair consideration for the transfers or obligations or both undertaken by the Bankrupt in October.

IV.

THE OCTOBER TRANSACTION IS A FRAUDULENT CONVEYANCE UNDER BANKRUPTCY ACT SECTION 67d 2(a) AND CALIFORNIA CIVIL CODE SECTION 3439.04.

> "Every transfer made, and every obligation incurred, by a debtor within one year prior to the filing of a petition initiating a proceeding under

> this Act by or against him, is fraudulent as to creditors existing at the time of such transfer or obligation if made or incurred without fair consideration by a debtor who is, or will be, thereby rendered insolvent without regard to his actual intent."

The trial court made its finding that the Bankrupt was not insolvent at the time of the October Transaction. In making this finding, the trial court erred.

Even taken in the light most favorable to the Respondent, the evidence shows that the Bankrupt's financial condition at this time was such that his liabilities exceeded his assets.

That evidence with regard to his assets is as follows:

The value of the Bankrupt's stock in trade, including 20% markup over cost price, was $30,000.00. (Tr. Rec. p. 348.)

The value of the accounts receivable was $25,000.00. (Tr. Rec. pp. 518, 219, 268, 348.)

The value of the Bankrupt's equity in his furniture and equipment was $2,000.00. (Tr. Rec. pp. 192, 268.)

The value of the Bankrupt's lot on Mt. Hamilton Road was $2,500.00. (Tr. Rec. p. 192.)

Thus the total value of the Bankrupt's assets as of the October Transaction was $59,500.00. These figures are taken from the most favorable evidence to the Respondent, and as will be shown below, exceed what the evidence shows as a true picture of the assets.

The evidence again taken in the most favorable light to the respondent, with regard to the Bankrupt's liabilities, is as follows:

The amount due to the Respondent was $28,000.00. (Tr. Rec. pp. 220, 518.)

The amount due on other business accounts payable, was $8,000.00. (Tr. Rec. p. 349.)

The amount due to Pearl K. Lannin was $13,000.00. (Tr. Rec. p. 428.)

The amount due to Charles Lannin was $13,000.00. (Tr. Rec. pp. 151, 344.)

The amount due the Bank of America was $2,000.00. (Tr. Rec. p. 344.)

Thus the total amount due by the Bankrupt, taken in the light most favorable to the Respondent, was $64,000.00, leaving under this view of the evidence an excess of $4,500.00 of liabilities over assets.

It is the contention of the appellants that the above picture of the assets and liabilities of the Bankrupt is not in conformity with the true state of the evidence. The valuation of the accounts receivable should be placed at a lesser amount than the $25,000.00 given them, for the value does not take into consideration any uncollectable or bad accounts and no aging of the accounts. (Tr. Rec. pp. 219, 220 and Plaintiff's Exhibits 3-4.) In the fourth letter of plaintiff's Exhibit 3, for example, Respondent, Hunter, called to the Bankrupt's attention the fact that he is dealing with slow and bad accounts.

Furthermore, the value of $30,000.00 placed upon the stock in trade does not take into consideration the fact that some of the stock was unsalable or at least not worth full book value. A realistic valuation would certainly be less than the $25,000.00 stated above.

The figure of $8,000.00 set out above for the amount due on other business accounts payable is taken from the testimony of the Bankrupt. (Tr. Rec. p. 349.) The testimony of the Bankrupt's accountant (Tr. Rec. 220), and of the Respondent, Ramsay (Tr. Rec. p. 518), placed this amount at approximately $12,000.00.

It is the belief of the Respondents that the trial court erred in its findings regarding the solvency of the Bankrupt, because of the great mass of evidence involved in the trial regarding the knowledge of the Bankrupt's insolvency by the Respondents. For the present purpose it is urged only that the court erred in the finding of solvency regardless of the knowledge of the Respondents.

CONCLUSION.

Under any of the subsections mentioned in our arguments the October transaction was a fraudulent conveyance. Under the urging of Respondents the Bankrupt devised a plan which included an actual intent to hinder, delay or defraud present and future creditors. Respondent had complete knowledge of the Bankrupts intentions and was so close to the transactions and benefits received from them that its implication in the intention is evident. The transaction

was made while the Bankrupt was insolvent and left him without a reasonable amount of capital to carry on the business. The Respondents did not give a fair consideration for the transfers and obligations incurred. The Bankrupt made these transfers in secret from most of his creditors and yet retained practical control over his business. The Referee in Bankruptcy held the October Transaction to be a fraudulent conveyance as far as it related to Mrs. Lannin in litigation in which Respondents were not a party. The court below regarded the October Transaction as invalid as to payments pursuant to it and within 4 months of bankruptcy. This court should reverse the action of the court below insofar as it failed to invalidate the October Transaction in its entirety as a fraudulent conveyance.

Dated, San Jose, California,
July 15, 1957.

Respectfully submitted,
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